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TO RUEHC/SECSTATE WASHDC 0914
INFO RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOG/USDOC WASHDC
RUCPCIM/CIMS NTDB WASHDC

UNCLAS KYIV 000113

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E.O. 12958: N/A

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SUBJECT: UKRAINE: 2007 INVESTMENT CLIMATE STATEMENT

REF: 2006 STATE 178303

1. As requested reftel, below is the 2007 Investment Climate Statement (ICS) for Ukraine. Post is transmitting the ICS in three separate parts due to its large size. Post will send the ICS in Microsoft Word version to EB/IFD/OIA by email.

Begin Text:

A.1. Openness to Foreign Investment

GOVERNMENT'S ATTITUDE TOWARDS FOREIGN INVESTMENT

When President Viktor Yushchenko took office in January 2005, he made improving the investment climate one of his top economic policy goals. This led to a number of new government initiatives, such as creation a State agency for investment and innovation and a number of investor councils chaired by the President. Additionally, there have been several positive steps for U.S.-Ukraine trade and investment relations over the past year. Both the United States and the European Union granted Ukraine market economy status, in February 2006 and December 2005, respectively. In March 2006 the United States terminated the application of the Jackson-Vanik amendment to the Trade Act of 1974 to Ukraine, providing Ukraine permanent normal trade relations status. International investment companies rushed to take advantage of the improved mood and held several large-scale Ukrainian investment conferences in 2005 and 2006, both in Ukraine and abroad. Political uncertainty dampened investor enthusiasm during the run-up to the March 2006 parliamentary elections, and in the ensuing five months it took for Ukraine to form a government.

After eight years of decline following independence, the Ukrainian economy has been growing since late 1999, with real GDP growth at about 7% in 2006. Over the past few years, Ukraine has liberalized its markets, reduced regulation, eliminated most licensing requirements, eliminated most restrictions on foreign exchange and begun the transformation of the agricultural sector from state-run farms to private agriculture. After years of hyperinflation and plummeting currency values, the national currency, the hryvnia (UAH), has been stable against the U.S. dollar for over five years. The National Bank of Ukraine (NBU) allowed it to appreciate about 5% in early 2005, but has maintained a nearly constant exchange rate to the dollar since then. The inflation rate fell from 2004's 12.3% to 10.3% in 2005, and was expected to be between 10%

and 11% in 2006. Ukraine remains in need of substantial reforms in order to achieve full economic liberalization. Ukraine's economy is still shackled by corruption, poorly developed rule of law, over-regulation, and excessive government interference in what should be private business decisions.

Ukraine was not able to achieve its goal of entering the WTO in 2006, but made significant progress during the year. Ukraine's Verkhovna Rada (parliament) passed about 20 pieces of legislation helping to bring its trade regime into consistency with WTO rules. Ukraine also made progress on its bilateral market access agreements, most notably with the signing of a bilateral agreement with the United States on March 6, 2006. Ukraine must still conclude its last bilateral agreement with Kyrgyzstan.

Foreign investors continued to express little confidence in the Ukrainian court system. In a growing number of cases, predatory minority shareholders have been able to procure dubious court decisions in an effort to wrest control of companies away from the majority investors. Around a dozen such attacks, which targeted both Ukrainian companies and major foreign investors, occurred over the past year. Ukrainian courts have a long record of striking down or ignoring contractual provisions that assign legal responsibility for dispute resolution to a foreign court or arbitrator. Many investor complaints over the years have involved the State Tax Administration's (STA) selective enforcement of tax policy. Businesses have claimed that STA local and regional branches use investigative authority to advance favored political or business interests. While the number of such complaints dropped in 2005, exporters have suffered from the STA's failure to refund VAT payments on inputs in a timely fashion. Although some improvements in payment of refund arrears occurred in late 2005 and early 2006, in August 2006, the GOU again decreased the pace of VAT refunds, reimbursing only 76 percent of verified claims, down from 87 percent refunded in 2005. At year's end, several major exporters are facing large and continuously accumulating arrears.

MAJOR LAWS/RULES AFFECTING FOREIGN INVESTMENT

Ukraine's law "On the Foreign Investment Regime" (1996) provides for equal treatment of foreign and Ukrainian-owned business with some restrictions in broadcasting and weapons manufacturing. Although Ukraine passed several laws in the 1990s that provided tax privileges to joint ventures with foreign participation, by 2002, these privileges had been cancelled.

In early 2005, Ukraine lifted all tax and tariff exemptions to investors in Special Economic Zones (SEZ) in order to stop large-scale misuse of the zones. Some investors criticized the abrupt cancellation of the privileges and the absence of any compensatory provisions, and they said these actions destabilized the investment climate. U.S. investors with planned or existing investment in the SEZs faced substantial losses from the elimination of these privileges. The new government of Prime Minister Viktor Yanukovich has announced its intention to re-establish some tax and customs privileges for investors and export processors located within SEZs, and stated it would develop a compensation mechanism for investors who suffered from the 2005 cancellation. By year's end, no action was taken to re-establish the SEZs and the planned privileges were not defined.

Both a new Civil Code and a competing and incompatible new Commercial Code went into effect on January 1, 2004. Lawyers and judges continue to grapple with how to implement the two conflicting laws, which also contradict some existing legislation. In 2005, the Ukrainian government proposed to annul the Commercial Code, but as of the year's end, no corresponding new draft legislation has yet to be registered in the parliament.

On October 25, 2001, the Ukrainian Parliament passed a Land Code. It provides for private ownership of land, facilitating the privatization of land for agricultural purposes, but also provides for a moratorium on agricultural land sale until January 1, 2008. Individuals will not be able to acquire or sell agricultural lots larger than 100 hectares between 2008-2015. The Land Code includes a 20-year moratorium on agricultural land sales to foreigners, though foreigners may own land plots on which industrial facilities have been built. Efforts to cancel the moratorium in 2007 have failed. The Rada voted to override President Yushchenko's veto of the moratorium, citing the need to first strengthen the legal framework covering land sale, while Yushchenko called on the Rada to hasten passage of legislation necessary to end the moratorium. Such restrictions may delay the development of a functioning land market, but the overall picture is not entirely negative, as there is an active market in agricultural land leasing.

A new Customs Code went into effect January 1, 2004, codifying uniform procedures for all goods, and creating a mechanism for submitting a preliminary declaration for customs clearance for those who declare items on a regular basis. The Code widened the powers of the State Customs Service (SCS), granting its staff free access to the companies' premises where commodities subject to customs clearing are stored. It also gave the SCS the power to review foreign trade companies' financial and economic performance. Both provisions are considered consistent with WTO norms. December 2005 amendments to the Customs Code and Single Customs Tariff brought Ukraine's customs regime almost fully into compliance with the WTO Customs Valuation and Rules of Origin Agreements.

Under the 2001 law, "On the Customs Tariff of Ukraine," only the Rada can introduce or change tariffs. The import tariff system of Ukraine has 21 sections, encompasses 97 groups of goods, and lists over 11,000 import duty rates. Between March and July 2005, the parliament passed three packages of amendments to the Customs Code of Ukraine to decrease tariff rates. These measures brought the normal average tariff rate down to 6.5 percent, or more specifically to 13.8 percent (down from 19.7 percent) for agricultural goods and 4.4 percent (down from 8.3 percent) for industrial goods.

Ukraine's anti-monopoly committee implements anti-monopoly, competition, and consumer protection legislation under the March 2002 law "On Protection of Economic Competition." New companies and mergers/acquisitions face strict controls. Most investments, joint ventures with multiple partners, and share acquisitions require the committee's approval. The law requires that the Committee obtain a court order before entering private property. Those violating fair competition rules may be fined up to 10% of the prior year's turnover. If unfairly gained profit exceeds 10% of income, up to three times the normal penalty can be collected. Legal experts have expressed concern over restrictions on who may appeal a Committee decision.

PRIVATIZATION AND FOREIGN PARTICIPATION

Ukraine's privatization law provides for the cash sale of majority shareholdings in state enterprises, open bidding procedures, and the use of independent financial advisers to assist Ukraine's State Property Fund (SPF). In practice, however, privatizations conducted between early 2000 and 2004 were non-transparent and arbitrary -- and were marked by heavy behind-the-scenes political interference. In 2005, the new government of President Yushchenko undertook a review of past privatizations with the professed intent of invalidating those found to have been corrupt reselling the enterprises. The government secured a court ruling invalidating the May 2004 privatization of Ukraine's major steel plant, Kryvorizhstal, which the son in law of then-President Kuchma acquired for \$800 million. The GOU conducted a new

transparent tender open to international participation and sold the enterprise to Mittal Steel in October 2005 for \$4.8 billion. The government's failure to articulate a clear policy regarding past privatizations other than Kryvorizhstal created significant uncertainty among business owners and prospective investors. By early 2006, the government under Prime Minister Yuriy Yekhanurov dropped its effort to redress improper past privatizations and the Yanukovich government has not revisited this policy.

There were few new privatizations of major state enterprises in 2006. As of October 2006, only 15% (\$64 million) of the year's target for privatization had been transferred to the budget.

Ukrainian law formerly limited foreign participation in privatization of certain "strategic" enterprises (radio, television, energy, and insurance). Foreign shares of TV and radio broadcasting and publishing companies generally could not exceed 30%. On January 12, 2006, Ukraine's Parliament adopted a new law "On Television and Radio Broadcasting" that eliminated restrictions on the share of foreign capital in the charter funds of television and radio broadcasting companies. Foreigners are now prohibited from founding TV or radio stations, however. Ukrainian law continues to limit foreign participation in the privatization of a few "strategic" sectors, such as energy, although the Rada retains the authority to lift legislative restrictions on foreign ownership in specific instances, and has done so on occasion.

PROCUREMENT

Ukraine is not a signatory to the WTO Agreement on Government Procurement but is negotiating WTO accession. A March 2000 government procurement law favors Ukrainian bidders on contracts to sell goods and services, affording a 10% differential to domestic bidders over foreigners in certain cases. Foreign investors also complain about a lack of advance notice of rules and requirements for tenders, covert preferences in tender awards, hidden conditions on awards that are not defined in tender announcements, partiality towards domestic investors, and an inability to resolve grievances and disputes. The American Chamber of Commerce in Kyiv has reported that many firms are reluctant to pursue GOU procurement opportunities out of concern they will be unable to collect payment. Foreign companies generally win only a tiny fraction of the total tenders (0.01 percent during the first half of 2006). A law "On Production Sharing Agreements" (PSA), effective October 1999, provides a legal framework guaranteeing that the terms of agreements between foreign investors and the GOU for natural resources development cannot be changed once an investment is made. However, additional enabling legislation is needed in order to harmonize Ukrainian laws with the PSA's joint exploration and production license. Also needed are Cabinet of Ministers resolutions to establish special tax benefits envisioned by the PSA law, such as the amount of profit tax revenue the government will receive from the PSA producer. The development of PSA's is being tested after the GOU awarded the U.S. company Vanco a tender for the Prikercheskiy block for offshore oil exploration in the Black Sea. Vanco and the GOU are, as of the year's end, negotiating the terms of the PSA for this project.

In December 2005 Parliament adopted amendments to the law "On Procurement of Goods, Works and Services Using State Funds" of February 22, 2000. The amendments, which entered into force in March 2006, transferred the authority to coordinate government procurement from the Ministry of Economy to the Antimonopoly Committee of Ukraine. The authority to oversee government procurement was distributed among a range of agencies, including the Antimonopoly Committee, the Accounting Chamber of Ukraine, and the quasi-governmental Tender Chamber of Ukraine. The amendments have been criticized for creating an overlap in

authority of various regulatory agencies and decreasing the transparency of the system. Under Ukraine's amended law, the Tender Chamber has exclusive authority to review claims of tender participants and issue recommendations regarding single-supplier procurement. The measure introduces burdensome and lengthy procurement procedures, and requires all tender proposals to be secured by collateral, limiting the number of tender participants and increasing the cost of the tender participation.

Finally, the new law made it mandatory that procurement by state enterprises follow government procurement rules and procedures, rather than permitting the enterprises to make contracts on a commercial basis. This feature contradicts accepted international practice and commitments made by Ukraine in WTO negotiations. Ukraine is not currently a signatory to the WTO Agreement on Government Procurement (AGP), but will become an observer to the AGP at the time of WTO accession, and could start AGP negotiations by requesting membership one year after accession.

A.2. Conversion and Transfer Policies

RESTRICTIONS ON CONVERTING/TRANSFERRING FUNDS

The April 1996 "Foreign Investment Law" guaranteed the "unhindered transfer" of profits, revenues, and other proceeds in foreign currency after taxes and other mandatory payments. By intervening in exchange markets, the National Bank of Ukraine (NBU) maintains a de facto peg of Ukraine's currency, the hryvnia, to the dollar. In 2006, the hryvnia traded against the U.S. dollar at or near UAH 5.05 to the dollar.

While foreign investors may repatriate earnings, companies must obtain a license from the NBU for some operations. For repatriation of hard currency, each transaction over \$50,000 must be approved by the NBU. The NBU also charges a fee to review the transaction. In view of increased hard currency inflows, the NBU on March 31, 2005, canceled its 1998 surrender requirement that exporters convert half of their hard currency revenues into hryvnias. Foreign exchange is readily available at market-determined rates, which generally do not vary greatly from the daily official exchange rate. In February 2005, the NBU lifted the 2% limitation on deviation of bank exchange rates from the official exchange rate, which had been in effect since October 2004. A pension fund tax is levied on transactions to purchase hard currency. A 2005 GOU decision to reduce that tax from 1.5% to 1.2% of the amount of the transaction as of January 1, 2006 was never implemented, but the State Budget for 2007 includes a measure reducing the rate to 1.3%.

Foreign investors have complained of cumbersome NBU regulations (2005 Resolutions 280 and 281) requiring them to open local accounts in Ukrainian banks and to use the services of Ukrainian brokers in order to make investments in Ukraine. Past direct investors seeking to liquidate and repatriate their investments face stringent documentary requirements, though the NBU has stated its willingness to waive requirements if documents from the original transactions are no longer available.

Investors convert their earnings into foreign currency through commercial banks, which purchase foreign currency on the electronic inter-bank currency market. Commercial banks may trade foreign currency in electronic form with other banks through participation in electronic inter-bank currency market, regulated and operated by the NBU. To purchase hard currency, companies must provide their banks with a copy of their foreign trade contracts. In an attempt to expedite purchases of hard currency, in March, 2005, the National Bank of Ukraine cancelled the requirement that companies obtain State Tax Administration permission to purchase hard currency. Commercial banks must announce their clients' intentions to sell on inter-bank currency market if the transactions exceeded \$500,000.

The law "On the Circulation of Promissory Notes" provides an opportunity for payments in foreign currency and issuance and circulation of promissory notes, in accordance with the 1930 Geneva Convention "Providing a Uniform Law for Bills of Exchange and Promissory Notes." Residents may transfer up to USD 600 abroad without opening a bank account. Illegal trade of hard currency is not a criminal matter but brings administrative penalties.

A.3. Expropriation and Compensation

Under the 1996 law "On the Regime of Foreign Investment," a qualified foreign investor is provided guarantees against nationalization, except in cases of national emergencies, accidents, or epidemics. International institutions have recommended that definitions of expropriation and nationalization in the foreign investment law and bilateral treaties be expanded to include indirect and creeping expropriation. Courts can determine whether owners of privatized enterprises failed to pay for an enterprise or to implement investment commitments in a privatization sale. Failure to pay or invest allows the GOU, with court permission, to revoke ownership and resell the property.

A.4. Dispute Settlement

EXTENT AND NATURE OF INVESTMENT DISPUTES

The Embassy continues to provide advocacy on behalf of U.S. investors. For many years, investment disputes frequently have involved key problems with the investment climate such as the lack of adequate rule of law, fair and impartial dispute resolution mechanisms, and enforcement of domestic court and international arbitration decisions. Another problem is poor corporate governance (inadequate protection for shareholder rights, inadequate disclosure, asset-stripping, and voting fraud). Dispute settlement remains weak. Currently, there is no single point of contact in the Ukrainian government committed to helping resolve business and investment disputes. Most U.S. businesses have little confidence in Ukrainian courts. Commercial contracts may permit the parties to use international arbitration or specified foreign courts to settle disputes. Though Ukrainian legislation recognizes international arbitration decisions, in practice such decisions are very difficult to enforce in Ukraine.

Corruption continues to lie at the heart of many investor disputes. Laws and regulations are vague, with considerable room for interpretation, providing officials at every bureaucratic layer ample opportunities for corruption. Foreign investors are often seen as competitors to domestic firms and their allies in the government.

DESCRIPTION OF UKRAINE'S LEGAL SYSTEM

Ukraine has a civil law system relying on codes and separate legislative acts. The court system comprises the Constitutional Court, which interprets the Constitution and laws of Ukraine, and a system of courts of general jurisdiction. The courts of general jurisdiction are further divided into general courts, which handle civil, criminal, and administrative matters, and specialized commercial courts, which review business disputes, bankruptcy, and anti-monopoly cases. Both the general and commercial court systems feature a hierarchy of local and/or regional courts and appeals courts. The Supreme Court of Ukraine is the highest court in the system of courts of general jurisdiction.

The law "On the Judiciary," in force as of June 2002, creates four levels of courts -- local courts, courts of appeal, courts of cassation (higher specialized courts) and the Supreme Court. This law also establishes an independent judicial department, the State Judicial Administration, to manage the court system, with the exception of the Supreme Court, which is self-administered.

The law did increase the independence of the judiciary; but it also in some cases increased the powers of the President over the judiciary. While the law envisioned the creation of a separate system of Administrative courts, this system is not yet fully set up. The Supreme Administrative Court started its work only in the fall of 2005. The Administrative Procedural Code, which entered into force on September 1, 2005, governs the organization and work of the administrative courts.

The National Commission on Democracy and the Rule of Law prepared a "Concept of Improvement of the Judicial System," signed by President Yushchenko on May 10, 2006. The document outlines a program for comprehensive judicial reforms, but has yet to be implemented.

ENFORCEMENT OF RIGHTS

Investors criticize Ukraine's legal system for its inefficiency, burdensome procedures, unpredictability, corruption, and susceptibility to political interference. Even when they obtain favorable decisions, investors claim the decisions are rarely enforced. The enforcement responsibilities fall under the State Enforcement Service, which reports to the Ministry of Justice, but whose head is appointed by the Cabinet of Ministers.

The procedure for recognizing and enforcing foreign court decisions is regulated by Section 8 of the Code of Civil Court Procedures of Ukraine. In accordance with the Code, a foreign court decision is recognized and enforced in Ukraine if such recognition and enforcement is provided for in international treaties, the mandatory nature of which has been endorsed by the Rada, or based on a mutual ad-hoc agreement with a foreign state whose court has rendered a decision that is to be enforced in Ukraine.

The State Enforcement Service implements decisions rendered by foreign courts and arbitration tribunals in accordance with the law "On Enforcement Proceedings." The law "On Implementing Decisions and Applying Practices of the European Court of Human Rights" entered into force on March 30, 2006. Along with a subsequent Cabinet of Ministers implementing Resolution, the law obligates the Ministry of Justice to ensure implementation of the Court's decisions.

COMMERCIAL LAW

A new Civil Code and a competing and incompatible Commercial Code both went into effect on January 1, 2004. Lawyers and judges have since grappled with how to implement the two conflicting laws. Despite heavy criticism of the Commercial Code by businessmen and GOU officials, the Rada has not yet taken action to amend or annul it. The Civil Code ensures protection of the rights of private property, of engaging in contracts, and of entrepreneurial activity. It provides a unified framework for economic regulations.

The Civil Code is generally market-oriented and modern, but the Commercial Code is often contrary to market economy principles and directly contradicts provisions of the Civil Code in numerous instances. The Commercial Code aims to preserve a privileged position for the public sector of the economy and allows for governmental interference in private commercial relations. Further, in both codes gaps in regulation exist. The existence of these two codes creates uncertainty in planning and structuring transactions, and leaves questions surrounding transactions unanswered. Problems arising from these two codes also surface in the resolution of disputes, as courts are not able to resolve the conflicting provisions of the codes, or are not able to fill in the gaps in regulation that arise as a result of the missing provisions in the codes. Finally, other

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commercial laws have not been harmonized with these codes.

A 1999 bankruptcy law provides for debtor-led

reorganization, a meaningful moratorium on payment and collection of pre-existing debt, and a tax forgiveness provision. The 1999 law provided thousands of heavily indebted industrial enterprises with an alternative to liquidation that did not exist under Ukraine's original 1992 bankruptcy law. Since then, many firms have reached amicable settlements with their creditors and established a workable schedule of debt forgiveness and repayment. Creditors protect their rights under the law by electing a creditors' committee, which is actively involved in the bankruptcy proceedings.

Most observers believe the bankruptcy laws must be amended to provide more protection for creditors. Notice provisions, protections for the rights of minority shareholders, and procedures for valuation and the sale of assets to satisfy liabilities are undeveloped.

CORPORATE GOVERNANCE

Problems with corporate governance in Ukraine involve corporate ownership, shareholder rights, transparency, and disclosure. The law "On Companies" offers scant protection for minority shareholders against insider dealing, asset stripping, profit skimming, and share dilution. Corporate finance is restricted. Some examples of shareholder rights abuses include limited disclosure, capital restructuring without shareholders' consent, and shareholder voting fraud. Nevertheless, a Company Register that was established in 2004 improved transparency. A new Joint Stock Company law was first drafted in 1998 to improve the current law by introducing sound corporate practices that meet international standards. It has failed repeatedly in parliament, despite increasing interest in the business community. The Rada has not yet considered the most recent version of this law, submitted in June 2006.

BINDING INTERNATIONAL ARBITRATION

Ukraine enacted an international commercial arbitration law in February 1994, which parallels commercial arbitration laws set forth by the United Nations Commission on International Trade Law. Ukraine is a member of the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitration Awards. Some investors have problems enforcing foreign arbitration awards in Ukraine. Foreign arbitral award enforcement procedures in Ukraine are regulated by a number of statutes and regulations, including the Section 8 of the Civil Procedural Code and a law "On Enforcement Proceedings." In early 2000 Ukraine ratified the Washington Convention, providing for use of the International Center for Settlement of Investment Disputes (ICSID), an internationally recognized mechanism for resolving investment disputes between investors and the GOU. The U.S.-Ukraine Bilateral Investment Treaty (BIT), signed in November 1996, recognizes arbitration of investment disputes before the ICSID. One major investment dispute involving a U.S. company was resolved in May 2006 through a combination of direct consultations with the Ukrainian government and international arbitration by

ICSID.

TAYLOR